No. 12,054

IN THE

United States Court of Appeals

For the Ninth Circuit

PACIFIC PORTLAND CEMENT COMPANY, a corporation,

Appellant,

vs.

WESTVACO CHLORINE PRODUCTS CORPORATION, a corporation,

Appellee.

APPELLANT'S OPENING BRIEF.

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OPINION BELOW.

The opinion of the district court (R. 67) is reported at 77 F. Supp. 406.

STATEMENT AS TO JURISDICTION.

This is a suit for declaratory and other relief brought under 28 U.S.C. § 400 (now 28 U.S.C. § 2201) by appellant, a California corporation (R. 2, 48), against appellee, a Delaware corporation (R. 2, 48). The complaint alleged (R. 3) and the answer admitted (R. 18) the existence of a controversy regarding the provisions of a contract between the parties, and that the value of the matter in-

volved in the suit is in excess of $3,000, exclusive of interest and costs (R. 2, 18). The district court found these facts to be true (R. 48, 49, 50). The complaint prayed, *inter alia,* judgment against appellee in the amount of $9,405.93 (R. 7). A declaratory judgment was entered April 26, 1948 (R. 63-66), timely notice of appeal was filed May 25, 1948 (R. 74-77), and the appeal was duly perfected (R. 83, 84, 85, 1314, 1319).

The district court had jurisdiction under 28 U.S.C. § 400 (now 28 U.S.C. § 2201) and 28 U.S.C. § 41(1) (now 28 U.S.C. § 1332(a)(1)). This court has jurisdiction under 28 U.S.C. §225(a) (now 28 U.S.C. §1291). The pleadings necessary to show the existence of the jurisdictions are the complaint (R. 2-13) and the answer (R. 17-34).

STATEMENT OF THE CASE.

In 1936, appellee's predecessor, California Chemical Company, was contemplating the construction at Newark, California, of a chemical manufacturing plant (R. 747, 756, 773), and the plant was constructed during 1937 (R. 743, 744). It was "primarily designed to produce magnesium oxide in its various forms," and would "produce as a by-product substantial quantities of gypsum" (Def. Ex. G, R. 750, 751). Seeking a market for this by-product (R. 773), appellee's predecessor approached appellant (R. 773) and the ensuing negotiations (R. 756) resulted in a contract dated January 29, 1937 (Def. Ex. G, R. 750). This contract provides for the sale by appellee and the purchase by appellant of "the entire output of by-product gypsum" produced at the plant in excess of certain limited require-

ments of the seller (R. 751). Its term is to January 31, 1962, subject to appellant's right to terminate it upon giving one year's notice of termination to the seller (R. 752). Almost immediately upon the execution of the contract appellee Westvaco acquired the plant and succeeded to all the rights and obligations under the contract of California Chemical Company (R. 748, 771).

Appellant's complaint (R. 2-13) in three counts alleged controversies under the contract, and sought declaratory relief construing its paragraphs (3), (5) and (6) (R. 7). The third count, which involved paragraph (3) of the contract, is not here in issue. The answer admitted the controversies (R. 18) and also sought declaratory relief (R. 33). The answer further pleaded numerous affirmative defenses and three counterclaims, and appellant filed a reply to the counterclaims (R. 34, 35) and an amendment to the reply (R. 37, 38). Excepting the first defense to each of counts one and two (R. 18, 27), these defenses and counterclaims are not in issue upon this appeal.[1]

Paragraph (6) of the contract.

The principal dispute concerns paragraph (6), the so-called "escalator" or "price-protection" clause. The contract fixed an initial price of $2.80 per ton (Def. Ex. G,

[1]The affirmative defenses raised the issues of the statute of frauds; that the contract is void for want of consideration, lack of mutuality and uncertainty; that appellant is barred by estoppel, waiver, material breaches, the statute of limitations and laches; and that the complaint does not state a claim upon which relief can be granted (R. 21-27, 28, 29). All of these issues were determined adversely to appellee (R. 48, 49, 58, 63).

The first counterclaim was compromised (R. 39-41, 56), and the issues of material breach raised in the second and third counterclaims (R. 31, 32) were determined adversely to appellee (R. 49). All the counterclaims were dismissed (R. 66).

R. 750, 753) for the by-product gypsum, and then provided in paragraph (6) (R. 754):

> "In the event that California's cost of production of gypsum for any twelve (12) months' period during the term hereof shall increase five per cent (5%) above its average cost of production of gypsum for the preceding twelve (12) months' period, then and in that event California shall have the right, upon giving sixty (60) days' written notice to Pacific, to increase the price payable hereunder for gypsum thereafter delivered hereunder in an amount *not to exceed the actual advance in California's cost of manufacture;* provided that in no event may more than one such increase be made in any one calendar year."[2]

Over the years appelee has claimed three price increases (Plf. Ex. 1, R. 99, 100; Plf. Ex. 2, R. 119, 120, 121; Plf. Ex. 10, R. 220, 221), which altogether would bring the price to $4.36 per ton (R. 219). Appellant contends that the proper application of paragraph (6) brings the price to not more than $3.52 per ton, and resists portions of the last two increases which in its view are not authorized.[3]

Appellee based its first price increase (effective October 5, 1941) upon a claimed increase of 18 cents per ton in the "cost of production of gypsum" for the period July 1, 1940, to June 30, 1941, over such cost for the preceding twelve months, July 1, 1939, to June 30, 1940. This increase brought the initial contract price of $2.80 per ton to $2.98

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[2]Italics throughout the brief are ours unless otherwise indicated.

[3]Since entry of the judgment below, a fourth increase has been claimed of 87 cents per ton, to bring the price to $5.23. The propriety of a part of this increase will depend upon the final disposition of this case.

(Plf. Ex. 1, R. 99, 100). Under circumstances hereafter related, appellant paid this new price without objection.

The second increase claimed was to become effective March 15, 1944, but remained inoperative because of O.P.A. price control until September 4, 1946 (R. 205, 215). It was based on the higher cost of production for the calendar year 1943 over that for 1942, and was asserted in the amount of 78 cents per ton. This would bring the price of $2.98 per ton to $3.76. Appellant promptly protested that appellee had not determined its cost of production of gypsum in these two years in accordance with the contract and that in fact the 1943 cost was only 29 cents per ton over the 1942 costs, bringing the contract price from $2.98 per ton to $3.27[4] (Plf. Ex. 4, R. 151-153).

The third increase, to be effective November 13, 1946, was claimed in the amount of 86 cents per ton, based on an asserted 86-cent per ton increase in the cost of production of gypsum for the period July 1, 1945, to June 30, 1946, over the cost for the preceding twelve months, July 1, 1944, to June 30, 1945. Appellee later reduced this claimed increase to 60 cents per ton. This would bring the asserted price of $3.76 per ton (including the full

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[4]At the trial appellant questioned appellee's methods of charging taxes and insurance on the gypsum portion of the plant. Objection to these items is not urged upon the appeal. The insurance charge increased 1 cent per ton in the period of the second increase and decreased 1 cent per ton in the period of the third increase (R. 565). The proper amount of the second increase is thus 30 cents per ton and the price payable from September 4, 1946, to November 13, 1946, is $3.28. The later decrease in insurance offsets by 1 cent the amount of the third increase appellant considered proper, making it 24 cents per ton. This leaves the price payable under appellant's views from November 13, 1946, at $3.52 per ton and leaves the portion of the price presently in dispute at 84 cents per ton.

amount of the second raise) to $4.36. Again appellant protested that appellee's cost of production for these two periods had not been determined in accordance with the contract and that the further cost increase was only 25 cents per ton (Plf. Ex. 13, R. 232, 234-238, 241-244). This would bring the prior price of $3.27[5] (including only the correct amount of the second raise) to $3.52 per ton.[6] Thus the price claimed is disputed to the extent of 84 cents per ton, because of appellant's objections to portions of the second and third increases.

That part of the price claimed that is in dispute was paid to appellee under protest up to the time the complaint was filed (Findings of Fact, R. 53, 54), and in addition to declaratory relief the complaint asked a money judgment for these payments amounting to $9,405.93 (R. 7). Under a stipulated order of the district court, appellee has received and is currently being paid the full price claimed for gypsum delivered after the filing of the complaint, but if it is finally determined herein that lower prices were properly payable, appellee is to refund any overpayments made either before or after the filing of the complaint (R. 43-47). At the time this order was entered on April 26, 1948, the payments made exceeded the amount appellant contends should have been charged by $37,603.61 (R. 44), in addition to the $9,405.93 sought to be recovered in the complaint.

The district court held, generally, that appellee had correctly determined its cost of production of gypsum in the several periods in question (R. 63, 64). Appellant contends

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[5]See note 4, supra.
[6]See note 4, supra.

that this ruling is contrary to the contract, to the evidence and to the law applicable thereto and is clearly erroneous in the particulars hereinafter set out. In so ruling, the court held that appellant had the burden of proving that appellee improperly determined the cost of production of gypsum and that the disputed price increases were unjustified (R. 73). Appellant contends that this also was error—that since appellee has the affirmative of the issue whether its costs have increased, and to what extent, appellee has the burden of proving the increases it asserts.

Paragraph (5) of the contract.

The method of sampling by which to determine the conformity to the contract requirements of the gypsum sold is also in question. For nine years, from 1937 to late 1946, the parties based their analyses on a sample of each carload (R. 212, 213, 868), such samples being taken by appellee at its plant and furnished to appellant's laboratory and its own (R. 212). Late in 1946 appellee for the first time refused to furnish carload samples (R. 213) and has since furnished only a composite sample representing a week's production, or approximately twenty carloads (R. 212, 213, 868). The district court determined that a composite sample of the aggregate quantity of gypsum shipped to appellant in a 24-hour day should be used (R. 65, 66). Appellant contends that the court erred in so ruling; that the carload method, consistently followed by the parties for nine years under the contract, is the proper method.[7]

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[7]A further controversy under paragraph (5) raised in the court below concerned the method of calculating deductions from price for product deficient in gypsum content (R. 5-6). Appellant does not urge this point on the appeal.

Appellee's Manufacturing Process.

Appellee's plant manufactures magnesium oxide, bromine, and the by-product gypsum. In general, the processes employed are as follows:

(1) The initial raw material, known as "bittern," is the liquid remaining after concerns such as Leslie Salt Company (R. 802) have precipitated the salt from sea water taken from the bay (Plf. Ex. 3, R. 128, 129). The bittern is purchased by appellee from the salt producers under long-term contracts (Plf. Ex. 3, R. 128, 129) and received into storage ponds (R. 802).

(2) The raw bittern has a slight and variable alkalinity, which makes further processing difficult (Plf. Ex. 3, R. 128, 133). Because of this condition, sufficient sulphuric acid to give essential neutrality is added to the bittern as it is withdrawn from the storage ponds into feed ponds (R. 803; Plf. Ex. 3, R. 128, 133).

(3) The neutralized bittern flows to bromine separation towers where bromine is removed (R. 803, 831) and most of the bromine is utilized in the manufacture of a product called ethylene dibromide (R. 948). In September, 1945, production of bromine was temporarily discontinued (R. 1016), and this step in the process eliminated (R. 827, 926).

(4) The neutralized bittern (with the bromine removed when the bromine towers are operating) contains, among other constituents, magnesium chloride and magnesium sulphate (R. 802). In order to utilize the magnesium and produce magnesium oxide, it is necessary to remove the sulphates (R. 818, 820, 821) which would otherwise constitute an impurity and prevent or impede magnesium

oxide production (R. 819, 820). There is therefore added to it another chemical, calcium chloride (R. 820). A chemical reaction occurs, the sulphates being precipitated in combination with the calcium as calcium sulphate with two molecules of water (R. 821). This precipitate is separated (R. 822), dried and ground (R. 946, 947), and constitutes the by-product gypsum that is sold to appellant (R. 821, 946, 947).

(5) After this precipitate is removed, there remains in the bittern magnesium chloride (R. 823). Calcium hydroxide (or the equivalent, quicklime or dolomite) is next added (R. 823, 824), and a further chemical reaction occurs, magnesium hydroxide being precipitated and separated (R. 824). When further processed this precipitate becomes magnesium oxide (R. 824). There remains calcium chloride, which is returned to the step in the process described in paragraph (4), and is there added to new quantities of neutralized bittern coming from the feed ponds or from the bromine towers when they are in operation (R. 804, 824).

Steps (4) and (5) are shown in graphic form on a large chart (Plf. Ex. 16, admitted R. 1244) which by stipulation and order is to be considered in its original form (R. 1324, 1325), and we respectfully refer the court to this chart.

SPECIFICATION OF ERRORS RELIED UPON.

1. The court erred in finding and concluding that appellee's cost of production of gypsum as determined by appellee from time to time and the resultant increases in

price claimed by appellee have been in accordance with the contract in suit, said finding and declaration being contrary to the evidence, to the contract and to the law applicable thereto in each of the particulars hereinafter specified.

2. The court erred in failing to find and conclude that for the purpose of establishing under the contract "the actual advance in [appellee's] cost of manufacture" and the resultant increase in price:

(a) Overhead expense and indirect charges cannot be included in appellee's determination of the cost of production of gypsum;

(b) Expenses totally unrelated to gypsum, in particular expense for "new products research," cannot be included in appellee's determination of the cost of production of gypsum;

(c) Appellee's expenses of a general and administrative nature cannot be included in appellee's determination of the cost of production of gypsum;

(d) Inconsistent accounting methods cannot be employed, in two cost periods being compared, in determining the cost of production of gypsum, and in particular in determining the costs, respectively, of sulphuric acid, indirect shipping expense and the air compressor;

(e) Depreciation expense cannot be increased by a calculation using the "straight line" method when, in the years compared, different quantities of gypsum are produced.

3. The trial court erred in holding that appellant had the burden of proving that the price increases claimed by

appellee were unjustified, said holding being erroneous for the reason that appellee has the affirmative of the issue whether its cost of production of gypsum has in fact increased as asserted by appellee and consequently has the burden of proving that the price increases claimed by it were justified.

4. The trial court erred in finding and concluding that for the purpose of analyzing gypsum sold to appellant to determine its conformity or nonconformity to the specifications of the contract, a composite sample of the aggregate quantity of gypsum shipped to appellant in a 24-hour day affords a fair and proper criterion of the gypsum delivered, and in concluding that such method of sampling is in accordance with the contract, for the reason that said finding and conclusion are contrary to the contract, to the evidence, and to the law applicable thereto, which require determination that a sample of each carload of gypsum shipped to appellant be used.

5. The court erred in finding and concluding that appellant was not entitled to judgment against appellee for the sum of $9,405.93.

SUMMARY OF ARGUMENT.

The contract in suit expressly declares that gypsum is a "by-product" produced in a plant "primarily designed to produce magnesium oxide." Paragraph (6) provides that if the cost of production of this by-product gypsum goes up in any 12-month period as compared to the preceding 12 months, the price may go up "in an amount not to exceed the actual advance in [appellee's] cost of manu-

facture.'' Under these terms, the cost increases upon which price increases may be based are subject to three specific limitations: The increased item of cost must be a cost of *production* as distinguished from an item of cost unrelated to production or manufacture. The increased item of cost must be a cost of producing the *by-product gypsum* as distinguished from an expense unrelated to gypsum. Finally, there is the over-all limitation that the increase may not exceed the *''actual advance''* in appellee's cost of manufacture. Whatever methods of cost accounting appellee employs for its own internal purposes, it is appellee's duty under this contract to limit the price increases it claims to the *''actual advance''* in the cost of *manufacture* of the *by-product gypsum*. Appellee has failed in its contractual duty so to limit its price increases.

(1) It is the meaning of this contract that the ''cost of production of gypsum'' comprises the ''direct'' items of cost. These are the items of cost directly attributable to, and identifiable in their relation to, the production of gypsum. Appellee has included in the cost of production ''indirect'' costs—costs that are unascertainable in their relation to gypsum production and would go on even if no gypsum were produced. The language of the contract dictates the exclusion of these costs. The negotiations of the parties prior to the execution of the contract clearly show that it was their intent to exclude them. Appellee's conduct after the contract was made shows it placed this interpretation upon the contract. The expert accounting testimony shows that of the methods of by-product accounting found in practice, the method required by this

contract is the one which excludes "indirect" costs from the cost of production of the by-product gypsum.

(2) Even if it should be held, contrary to our contention, that all indirect charges are not to be excluded in determining the cost of production of gypsum, nevertheless indirect charges totally unrelated to *gypsum* may not be included. Twelve cents per ton of one price increase was claimed by reason of appellee's charging to gypsum a portion of its expense for "new products research". This expense is not in any way related to gypsum production and even included a project seeking a way to eliminate gypsum production.

(3) In addition, even if all indirect charges are not to be excluded, the contract requires the exclusion of such charges as are not related to *production*. Six cents per ton of one price increase and 5 cents per ton of another were caused by appellee's charging to gypsum a portion of the general and administrative expenses of its west coast operations. The increases in these expenses, which are dissociated from production or manufacture, must be excluded from the price increases.

(4) Two cents per ton of one price increase was caused by appellee's changing the percentage of its indirect shipping expense charged to gypsum; and one cent per ton of the same increase was caused by a change in the percentage of the expense of an air compressor charged to gypsum. There was no actual advance in either cost. The claimed increases were purely fictitious, resulting from the use by appellee of inconsistent accounting methods in the periods compared and must under the contract be excluded from the price increase.

(5) Twenty-three cents per ton of one price increase was caused by appellee's reassignment among its products of the cost of sulphuric acid—a material that from the beginning has always been used and served the same function in gypsum production. Its cost has always been present, and there has been no actual advance in its cost. Under the contract the fictitious increase shown on appellee's books solely by reason of a change in accounting procedure must be excluded from the price increase.

(6) Seven cents per ton of one price increase was claimed because, under the "straight line" method of charging depreciation, one year's diminished production of gypsum created an "accounting" increase in depreciation expense when no actual advance in that expense existed. The contract requires the elimination of this fictitious increase from the price increase.

(7) In every proceeding the burden of proof is upon the party having the affirmative of the issue. This rule applies equally in a suit for declaratory relief even though the party having the affirmative is the nominal defendant. Appellee claimed and pleaded in its answer that cost increases have occurred and that it was entitled to resultant price increases. It has the affirmative of that issue, even though appellant because of the existence of the controversy invoked the jurisdiction of the court as nominal plaintiff. The trial court ruled that appellant had the burden of proving the cost increases had not occurred and the consequent price increases were unjustified; and rested its decision of the whole case upon this conclusion. This fundamental error requires a reversal of the judgment.

(8) The plain language of paragraph (5) of the contract requires that the conformity of each carload of gypsum to the contract specifications be determined. To make that determination, a sample of each carload must be taken for analysis—not a composite sample of the contents of several carloads.

ARGUMENT.

I.

INTRODUCTORY STATEMENT.

Preliminarily, we respectfully emphasize to the court the unusual importance to the parties of the questions involved upon this appeal. The decision of these questions will not only resolve an immediate dispute; it will establish principles of interpreting the contract which will govern the parties for a long remaining contract term as to future price increases appellee may claim. Upon their decision turn the prices applicable to the purchase, over a period of more than sixteen years, of very large annual quantities of gypsum. Production in the last 12-month period shown by the record (the year ending June 30, 1946) was 36,658 tons (R. 565). Upon an annual production of only 30,000 tons, the disputed portion of the price even now claimed would amount to $25,200 in a year and approximately $403,200 over the sixteen years. Even small differences in the price cumulatively involve large sums, and in addition, the principles upon which they are made may control in the determination of much larger items.

We wish also to emphasize to the court the practical result of the interpretation of the contract for which appellee contends. The asserted cost of production in the first full year of production under the contract (1938), including all the indirect and other charges appellee would make, was $2.67 per ton (R. 565). The price was $2.80, giving appellee a profit of approximately 5 per cent on this by-product. Today, upon a claimed cost of production of $3.12 (R. 565)—an increase of only 45 cents over the initial asserted cost—appellee claims a price of $4.36. This increase of $1.56 over the original price would give appellee a price advance of more than 3½ times the advance in the cost it asserts, and a profit of approximately 40 per cent, or eight times the initial profit.[8] Surely, the reasonable business men who negotiated and entered into this contract could not have intended such results as these in providing for price increases "in an amount not to exceed the *actual advance* in [appellee's] cost of manufacture." For the reasons hereinafter set forth we submit that the findings of the court on the issues presented upon this appeal are "clearly erroneous".[9]

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[8]These margins of profit are, of course, very much greater when the original and the presently claimed price are related to the direct cost in these periods. The direct cost in this first year of production (1938), including direct shipping expense and taxes, insurance and depreciation on the gypsum portion of the plant, was $2.11 per ton (R. 565, 573) and the initial mark-up over *direct* cost was 69 cents per ton, or approximately 33 per cent. The present mark-up over present direct costs is many times greater (R. 565, 573).

[9]Rule 52(a), Federal Rules of Civil Procedure.

"A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed" (*United States v. Gypsum Co.* (1947) 333 U. S. 364, 395).

Grace Bros., Inc. v. Commissioner of Internal Revenue (9 Cir. 1949, No. 11,976) '49-5 C.C.H. Federal Tax Service, par. 9181.

II.

WHAT APPELLEE MAY DO FOR ITS OWN INTERNAL PURPOSES IN ALLOCATING "INDIRECT" CHARGES IS IMMATERIAL. THE EXPRESS TERMS OF THE CONTRACT, THE DECLARATIONS AND CONDUCT OF THE PARTIES, AND THE ACCOUNTING TESTIMONY, SHOW THESE CHARGES MUST BE EXCLUDED IN DETERMINING THE AMOUNT OF ANY "ACTUAL ADVANCE" IN THE COST OF "MANUFACTURE" OF THE "BY-PRODUCT GYPSUM."

A. The language of the contract and the accounting testimony so show.

The question is how, under paragraph (6) of the contract before the court, the "cost of production of gypsum" and the "actual advance in [appellee's] cost of manufacture" are to be determined. The problem is one of interpreting the instrument, to arrive at what the parties intended for the particular purpose of calculating price increases under this contract. The methods by which appellee determines the "cost of production" of gypsum or any other product for its own internal purposes are not determinative. Whether or not accountants would agree that appellee's methods are appropriate, for its own internal accounting purposes, is of no concern. Appellee is a large national concern with many plants all over the United States (R. 772). It purports to employ a uniform national system of accounting (R. 156, 736, 944, 945), which treats everything as if it were a joint product or a co-product (R. 613). It is entitled to do so, for its own internal purposes. But that uniform national system or any other method of accounting, however widely used, cannot override the intent of the parties to this contract as to the calculation of price increases under it, as that intent is found in the instrument itself and the circumstances under which it was made. That intent, we

submit, is to base price increases on a comparison of the "direct" costs that are actually incurred in the manufacture of gypsum as distinguished from so-called "indirect" costs or general overhead costs. These "direct" costs comprise, in addition to operating and repair labor, Workmen's Compensation and Social Security taxes on the direct labor, operating and repair materials, water, power, gas, fuel oil (R. 567), and direct shipping expense (labor and power required to load the gypsum into railroad cars, and repairs to the loading equipment (R. 573)). They also include taxes and insurance upon, and depreciation of, the portion of appellee's plant that is devoted to gypsum production, if these items are properly calculated (R. 513-515, 650-653).

The terms "direct" cost and "indirect" cost as used by appellant are simply a short-hand mode of distinguishing the costs that are directly incurred in the manufacture of gypsum from those whose relationship to its production cannot be ascertained. In referring to "indirect" charges in this brief, appellant refers to those elements of appellee's cost which appellee admits would still be incurred in appellee's operations if no gypsum were produced (R. 1037), and which admittedly are unascertainable in their relation to gypsum production (R. 1235-1238). These charges include the variety of general overhead items shown on the third page of plaintiff's Exhibit 18 (R. 569), as well as appellee's indirect shipping expense, and the cost of the basic raw material, bittern, a portion of which was allocated to gypsum on a purely arbitrary basis (R. 1031). Charges for "interdepartmental water" and "supervision" complete the list (R. 565). They were all charged to gypsum on a

prorata basis "without any reason as to how or in what way the particular items specifically had to do with gypsum" (R. 1192). Most of these expenses were allocated between appellee's products in proportion to the direct labor charges to the products, although other bases of allocation have been used by appellee (R. 735, 736).

The rationale of the direct cost method was thus explained by Dean J. Hugh Jackson, Dean of the Graduate School of Business at Stanford University (R. 1197):

> "But most business men would not include as a charge to that by-product that portion of the general overhead which would go on just the same whether the by-product was produced or not. In other words, that product must stand on its own feet as to whether or not it will pay the organization to produce that product from the time it is split off from the main product * * *" (R. 1203).
>
> "* * * the business would have to determine whether or not, if I may use the figurative expression, they would let the material wash down the sewer or whether they would process it still further, and if they are going to process it still further, then I think that product has got to stand on its own feet and be charged only with the additional expense which would be incurred in the processing of it" (R. 1207).

Much of the record is devoted to the expert testimony of accountants who testified on the abstract issue whether or not their accepted method of cost accounting for the cost of production of a by-product, as distinguished from a main product, or co-product, would include an allocation of indirect expenses, in addition to the costs directly

and identifiably incurred in the processing of the by-product after its separation from the main stream of raw material. On this abstract question there was a divergence of opinion.[10] However, the independent accountants called by appellee recognized that the exclusion of indirect charges from cost of production of a by-product is an accepted and widely practiced method of accounting—indeed, the method most commonly found in practice (Farquhar, R. 1119, 1120; Maxwell, R. 1161-1166). None of these accountants, of course, testified as to the method of determining cost and price advances called for by this particular contract—a question of law for the court.

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[10]Appellant called four witnesses who testified on this question. In addition to Mr. Flick, vice president of appellant and a certified public accountant of many years' experience (R. 95, 96, 99), there were Kenneth Pryor, resident partner of Price, Waterhouse & Co. (R. 633, 634), Paul Webster, a partner of Haskins & Sells (R. 493), Walter Draewell of Lybrand, Ross Bros. & Montgomery (R. 621), and J. Hugh Jackson, a man of national stature, seventeen years Dean of the Graduate School of Business at Stanford University, for twenty-eight years a teacher of accounting and cost accounting, past president of the National Association of Cost Accountants and of the American Accounting Association, formerly in charge of all staff training throughout North America for Price, Waterhouse & Co., author of books on accounting, and a practicing cost accountant and consultant (R. 1197, 1200). All of these witnesses testified that, in their opinion, cost accounting for a by-product includes only the direct or actual cost (R. 259, 261, 262; 495, 496; 622; 634, 635; 1202-1204). Appellee called two independent certified public accountants, Mr. Farquhar and Mr. Maxwell. Each testified that, in his opinion, the preferable method of cost accounting for a by-product treats it the same as a main product or co-product (R. 1113, 1146), and assigns to it a portion of the indirect expenses of the manufacturing plant (R. 1111, 1135, 1136). Mr. Alexander of the firm of Peat, Marwick & Mitchell was also called by appellee and testified to the same effect (R. 1175, 1176, 1178), but it was brought out on cross-examination that Mr. Alexander's firm is appellee's regular auditor and that he had collaborated with appellee in the preparation for the trial of this case (R. 1186).

The testimony thus leaves it clear that, while experts might differ as to the preferable method of cost accounting for by-products, all eight expert witnesses who testified, either for appellant or appellee (with the single exception of the interested witness, Alexander) testified as a matter of general accounting principle either that the preferable method of accounting for by-products excludes indirect cost, or that this method is an accepted and widely used method.

Thus all the accounting testimony points up the significance of the contract's language. The contract emphasizes a distinction between gypsum and other products produced by appellee, in its conclusive[11] recital that the plant was "primarily designed to produce magnesium oxide" but in the course of this production would produce gypsum "as a by-product" (R. 8). Obviously the parties intended and emphasized by these words that gypsum was to be treated, for all purposes of the contract, as a "by-product" as distinguished from a principal product or co-product. The accounting evidence is that of two methods of by-product accounting, one gives it distinct treatment, and the other treats it as though it were like any other product. If the contractual recital is to have any significance, it must be concluded that the appropriate method under the contract is the one which recognizes the special characteristics of a by-product, not the one which ignores them.

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[11]California Code of Civil Procedure, section 1962, subsection 2: "The following presumptions * * * are deemed conclusive:
* * * * * * * * *

2. The truth of the facts recited, from the recital in a written instrument between the parties thereto, or their successors in interest by a subsequent title; * * *."

This is in accord with the entire purpose and plan of the agreement. The record establishes without contradiction that in considering the advisability of constructing its plant, appellee intended primarily to produce magnesium oxide, but that it sought to salvage a recovery from the gypsum precipitate, which would be a "valueless waste" (R. 133) unless further processing would make it saleable to appellant, whose cement plant was in close proximity (R. 788, 789). The parties clearly did not contemplate, and there is not one line of testimony in the record to suggest they contemplated, that the by-product gypsum should bear the general and administrative and other indirect costs that would in any event be incurred in the manufacture of the plant's principal product. Every writing that passed between the parties indicated not only that the original price was based upon direct costs, but that the only costs in contemplation of the parties were direct costs.

B. The circumstances under which the contract was made show that the contracting parties contemplated only direct cost.

In 1936, Stanley H. Barrows, the president of appellee's predecessor, approached J. H. Colton, vice president of appellant corporation, to seek a buyer for the output of by-product gypsum at the then planned Newark plant (R. 773). The favorable factor that this plant would be located near appellant's cement plant at Redwood City, gave marketability to the by-product gypsum, which would otherwise have been a "valueless waste" (R. 788, 789). The conversations between Barrows and Colton resulted in a letter from Barrows, dated June 5,

1936 (Plf. Ex. 5, R. 164), which outlined the terms of a contract and stated in paragraph 11 (R. 166):

> "Contract would contain certain price protection clauses to guard against increases in labor, fuel and supplies * * *."

Mr. Barrows was plainly concerned only with increases in only three items of direct out-of-pocket cost.

The proposal of June 5, 1936, was followed on September 18, 1936, by a more detailed draft of proposal submitted by Barrows (Def. Ex. H, R. 881-893). Paragraph 6 of this proposal (R. 888, 889) also shows that Mr. Barrows had in mind price protection only against increases in direct costs:

> "* * * in the event of price advances and [sic] labor, transportation, fuel or supplies, resulting in an increase of 5 per cent or more in cost * * *."

The proposal of September 18, 1936, reveals a further significant fact which the lower court did not perceive. The opinion states (R. 70):

> "The record does not show what, if any, cost figures were utilized in fixing the basic contract price of $2.80 per ton."

The initial price of gypsum provided in this proposal was $2.80 per ton (paragraph 4, R. 886). The same price became the initial price under the contract that was signed (R. 10). The price of $2.80 per ton was based upon California Chemical Company's direct costs.[12] Paragraph

[12]The direct cost in the first year of production (1938), including direct shipping expense and taxes, insurance and depreciation on the gypsum portion of the plant was $2.11 per ton (R. 565, 573). This allowed appellant a mark-up of 69 cents, or 33 per cent.

6 of the proposal states (R. 888, 889) that the prices "*are based upon the average direct cost to California to produce the materials covered by this agreement during the first year's operation* of the contemplated new plant proposed to be erected at Canal Head, Newark, California * * *."

Concerning this, Mr. Barrows testified (R. 798):

> "Q. It was upon that basis of your direct costs that this contract, proposed contract price of $2.80 a ton was based; is that it?
>
> A. Right. The direct costs at that time."

On the subject of his later discussions with Mr. Colton, Mr. Barrows testified (R. 764, 792, 794) that because his company's right of termination contained in his proposals was unacceptable to appellant, he did not want to be limited to labor, fuel and supplies—that other items were discussed (R. 766). He could not say what those other items were (R. 766). The most that Mr. Barrows could say with reference to what costs were to be included was, "My thought was to 'leave it to the acountants, what cost of production is'" (R. 872). Appellant does not contend that appellee is limited to labor, fuel and supplies; it agrees that all direct charges may be included. *But there is not one word of testimony in this record by Mr. Barrows or by anyone else that "indirect" or "overhead" costs were ever mentioned to or discussed with Mr. Colton or any other representative of appellant in the negotiation of this contract.* On the contrary, Mr. Colton testified that it was never suggested such costs could be used as a basis for price increases. The discussions were at all times limited to direct costs (R. 1095, 1096).

C. Appellee's practical construction of the contract after it was made shows it construed the contract as permitting price increases based only on increases in direct cost.

Not only did California Chemical Company (appellee's predecessor) consider in negotiating the contract that the "price protection" was to be against increases in direct costs; appellee's conduct more than four years after the contract was signed shows that it interpreted paragraph (6) to mean that price increases were properly based only on direct costs. In 1941, appellee notified appellant of the first price increase. It supported this increase by a statement of the costs which had increased, enclosing the statement with the following letter, dated October 2, 1941, to appellant's Mr. Canvin (Plf. Ex. 1, R. 99-101):

> "In accordance with request of yourself and J. H. Colton, while in conference with Mr. Wallace yesterday, we have analyzed gypsum production costs for the years ending June, 1940, and June, 1941. We are attaching hereto a recapitulation of labor, material and power costs which accounts for 15 cents per ton of the 18 cents per ton increase of which you have been previously notified, and which increase is effective October 5, 1941.
>
> If you desire further information in re the attached statement, or in connection with our basis of determining increase in cost, please call on the writer.
>
> Yours very truly,
> WESTVACO CHLORINE PRODUCTS CORP.,
> O. H. HURLBURT,
> Chief Accountant."

The statement attached to this letter made no reference whatsoever to any costs other than direct costs (R. 101). It was clear from the statement and the letter that appel-

lee considered "gypsum production costs" to be direct costs. The statement showed that 15 cents of the 18-cent per ton increase claimed was due to increases in only three of the direct costs, i.e., labor, materials and power. Assuming that the other three cents was due to other direct charges of a minor nature (R. 597), appellant paid the increased price without seeking further detail (Plf. Ex. 13, R. 232, 242). It was not until January of 1944 that appellee informed appellant it asserted the right to base price raises on "indirect costs," costs that would go on even if no gypsum were produced (R. 105, 596-600). Appellant promptly objected (Plf. Ex. 4, R. 151-153).

The court below attached unusual significance to this statement of the first price increase and drew from it an inference directly opposite to that stated above (R. 70-72). It expressed the view that appellant could not have "ignored" the fact that "one-sixth of such increase resulted from an increase in indirect costs" (R. 72), and treated the conduct of appellant in making no protest to this first price increase as a recognition that indirect costs could be charged to gypsum under the contract.

It is clear beyond controversy, we submit, that this conclusion is erroneous. It is not true, as the court said, that one-sixth of the increase "resulted from an increase in indirect costs" (R. 72). The statement contains no reference of any kind to indirect costs, and the unexplained 3 cents was obviously an amount that reasonably would be considered to cover only direct costs other than labor, materials and power. The court's error on this point is conclusively shown by appellee's corrected account of this first cost increase. Nearly three

years after the 1941 statement was sent to appellant, appellee supplied a new statement of the costs claimed to support the 1941 increase (Def. Ex. A, R. 351, 353, 355). This statement showed, contrary to the data given in 1941, that the total increase in appellee's direct costs at that time was only 9 cents, and for the first time revealed that the remaining 9 cents consisted of increased indirect charges (Def. Ex. A, R. 351, 355, subtotal). If the original statement had been in this form appellant of course would have been put on notice that indirect charges were being included. But the original notice, making no mention of indirect charges and erroneously magnifying the increase in direct charges, clearly did not put appellant on any such notice. On the contrary it gave appellant assurance that the 1941 increase was based only on direct charges.

D. Appellee's practices ignore and nullify the contract limitation that price increases may be based only on the "actual advance in [appellee's] cost of manufacture."

The very nature of "indirect" costs shows they were not within the contemplation of the parties when they provided that price increases should be "in an amount not to exceed the actual advance in [appellee's] cost of manufacture."

Appellee's experts agreed that the direct costs are susceptible of accurate ascertainment (Farquhar, R. 1127; Maxwell, R. 1148; and Alexander, R. 1187). Comparison of these charges, period by period, would definitely reveal any "actual advance" in the cost of manufacture. The indirect or overhead charges, on the other

hand, cannot be ascertained. It is for the very reason that these charges cannot be ascertained with respect to a given product that they are classed as "indirect" or "overhead" (Maxwell, R. 1150). Allocation of certain of these items on a labor basis has been made by appellee (Plf. Ex. 15, R. 276; Plf. Ex. 17, R. 557; Watt, R. 907). This, of course, produces only an estimate, and according to appellee's own accounting witness the labor basis is not "necessarily the sound measure of allocating overhead"; there are other methods more reliable (Farquhar, R. 1125, 1127).

Testifying with regard to the overhead items appellee has charged to by-product gypsum, as shown in appellant's Exhibit 18 (R. 563-573), appellee's expert Alexander stated that the allocation would be made "without any reason as to how or in what way the particular items specifically had to do with gypsum" (R. 1192).

A good example of how this operates was disclosed by appellee's office manager Watt. Although on the labor basis 7.8 per cent of all engineering costs were charged to gypsum, he admitted he knew nothing about the engineering services or whether any increase actually had occurred in engineering service devoted to gypsum (R. 1020, 1021). Nevertheless "Engineering" overhead charged to gypsum increased, according to appellee's figures, *eightfold* from 1941 to 1946 (Plf. Ex. 18, R. 563, 569). During the same period "Purchases and Stores" overhead increased *sixfold,* "Newark Shop and Maintenance" overhead increased *fivefold* (R. 569), and indirect shipping expense increased *fourfold* (R. 573). In contrast, direct charges, including direct shipping ex-

pense, taxes, insurance and depreciation, increased during the same period only a little over one-fourth—from $1.31 to $1.67 (R. 565, 573). Appellee has offered no explanation as to how these huge increases in bookkeeping charges are actually related to or were incurred by gypsum production.

These overhead and indirect charges to gypsum are not only based on hypothetical assumptions, at best resulting in estimates (Farquhar, R. 1128), but all of them would continue even if the by-product gypsum were not produced (Watt, R. 1036, 1037; appellee's answer to interrogatories 9(g) and 10(g), R. 1236, 1237, and 1238, 1239). Such increases as occur in these costs are attributable to the general conduct of appellee's operations and are not within the explicit requirement of paragraph (6) that the price increases must be in an amount not to exceed the *"actual advance"* in appellee's cost of *"manufacture"* of *"gypsum."*

It is a cardinal principle of interpretation that effect is to be given to every part of the contract (California Civil Code, sec. 1641). It would read the restrictive language of paragraph (6) out of the contract, to approve the practices appellee has followed, of increasing the price not only on account of actual increases in the ascertainable direct costs incurred in the manufacture of gypsum, but also on account of increases in the indirect costs of conducting its general business that, so far as gypsum is concerned, can be allocated only on the basis of hypothetical estimates.

Ever since this dispute arose appellee has insisted that it can charge to gypsum any and all costs that its uniform

national accounting system would assign (R. 112, 113). Mr. Williams, then assistant to the president of Westvaco, argued in 1944 that appellee could not change its uniform accounting methods for one particular purpose such as this contract (R. 173). It was pointed out to him at that time that appellee could easily keep a few auxiliary accounts for the contract, as appellant does when it has special contracts (R. 173). As Mr. Webster of Haskins & Sells testified, "It is not at all uncommon for a company involved in the sale of a particular product to make separate computations of its costs for the purpose of the contracts which may be entirely different from the cost shown on the books" (R. 515). Further, appellee has made changes in its general accounting methods for the purported purpose of accomplishing uniformity of accounting practices between appellee's various units (R. 938) and has insisted that these changes may reflect in an increase in the price of gypsum to appellant—even though certain of these changes have had the admitted effect of loading gypsum with costs previously borne by other products (Watt, R. 956, 957; 1006-1010).

It is not, we submit, the uniform national system of accounting employed by appellee nor such changes in its accounting methods as it may make for its own internal purposes, that govern price increases charged to appellant. It is the intent of the parties as found in the interpretation of *this contract,* and that intent, as is shown by the prior negotiations, appellee's subsequent conduct, and by the instrument itself, is to base price increases on increases in direct cost.

In point is *Lincoln Rug Co. v. East Newark Realty Corporation* (Ct. of Err. and App., N.J., 1948) 61 Atl. 2d 448. There the court had before it a lease which provided (p. 450):

> "If Landlord's *cost to produce* steam shall increase between the time of the signing of this lease and the beginning of the term provided for herein, Landlord shall, upon proof thereof, have the right to increase the charge to Tenant sufficiently to compensate Landlord therefor to the extent of Tenant's Steam consumption."

The court stated (p. 450): "The chief question of difficulty in the case goes to the expression 'cost to produce steam.'" The court found the answer to that question, not in abstract accounting principle, and not in the landlord's accounting practices, but in intent of the parties (p. 450):

> "The meaning of the term 'landlord's cost to produce steam' depends upon the construction of the contract, that is, the intention of the parties."

The trial court in that case had selected a firm of accountants to examine the landlord's accounts. The report of these accountants included in the "cost to produce steam" charges like those appellee has made in the case at bar. One of such charges was an allocation of the landlord's cost of electricity, based on a "guess" or estimate as to the amount used in the power plant where the steam was produced. The court ruled (p. 451) that "the price of steam should not depend on this kind of estimate," and that the contractual intent of the phrase "landlord's cost to produce steam" required the exclu-

sion of the allocated indirect items the accountants had allowed. It was the landlord's direct charges which the court found to comprise the "landlord's cost to produce steam."

While the phrase "not to exceed the actual advance in [appellee's] cost of manufacture" in a similar contract apparently has not been judicially construed, a number of cases have decided the meaning of the word "actual" in relation to cost, and have established that the word "actual" is a restrictive one which contemplates only direct costs and excludes the indirect or general expenses of doing business.

In *State v. Tonopah Extension Mining Co.* (1926) 49 Nev. 428, 248 Pac. 835, the court had before it the term "actual costs of extraction, transportation, reduction or sale of ores." It held (p. 837):

> "The common sense of the thing is that it means the money actually expended in the extraction, transportation, and reduction of ores. The word 'actual' is a word of limitation, as distinguished from all costs of conducting the business."

A kindred case was *Anaconda Copper Mining Co. v. Junod* (1924) 71 Mont. 132, 227 Pac. 1001. The phrase there construed was "actual cost" of extracting, reduction or sale of ore. Here also the court held the term was a restrictive one." * * * not all, but only the *direct* costs and expenses were contemplated * * *" (p. 1004).

In *Lexington and West Cambridge Railroad Company v. Fitchburg Railroad Company* (9 Gray), 75 Mass. 226, the case turned upon the meaning of the phrase "the actual cost" of running extra trains. One party to the

contract charged the other with a proportion of the entire annual cost and expense of its business. It was held that such charge was not proper (p. 230):

> "The term 'actual cost' in the agreement declared on, means money actually paid out for extra trains. All the items of expense, which are objected to, would have been incurred whether the extra trains had been run or not, except the wear and tear of the defendant's track * * *" [and that was covered in another part of the agreement].

It is just such expenses that we ask this court to exclude—the indirect costs that would have been incurred whether or not the by-product gypsum were produced.

In the case of *In re Directors of Old Colony R. Co.* (1904) 85 Mass. 160, 70 N.E. 62, the court held that the "actual cost" of grade crossing alterations by a railroad did not include certain interest charges. Its language is apt in the case at bar (p. 63):

> "* * * if such an item is to be included either under the term 'expense' or that of 'actual cost' then there is no logical limit to sweeping into such a classification everything that directly or collaterally calls for expenditure, or cost, or loss by a railroad company * * *. That such a construction would open the door to let in claims that would be not only large in amount, but uncertain and contingent in their character, is reasonably clear."

We submit that the uncertain character of appellee Westvaco's indirect charges has been fully demonstrated. Upon these authorities they should be rejected.

If indirect costs were not excluded, and if the phrase "not to exceed the actual advance in [appellee's] cost

of manufacture'' were not given the meaning contended for above, it could have only one other possible meaning, and one that is more restrictive to appellee. The alternative meaning of the phrase ''not to exceed the actual advance in [appellee's] cost of manufacture'' is that the aggregate of the price increases since the first year cannot exceed the 45-cent net increase in all its asserted costs from 1938 to 1946 (supra, p. 16). That would make the present price $3.25 per ton, which is 27 cents less than the price appellant has offered to pay.

III.

EVEN IF IT SHOULD BE HELD THAT ALL INDIRECT CHARGES ARE NOT TO BE EXCLUDED IN DETERMINING THE COST OF PRODUCTION OF GYPSUM, NEVERTHELESS INDIRECT CHARGES TOTALLY UNRELATED TO GYPSUM, AND INDIRECT CHARGES NOT RELATED TO PRODUCTION, MAY NOT BE INCLUDED.

A. Appellee's charge for ''new products research'' is totally unrelated to gypsum and its production and, under the contract, may not be used as the basis of a price increase.

What has been said demonstrates, we submit, that appellee's direct costs of producing by-product gypsum are the only costs which may be taken into consideration in computing price increases to be charged to appellant under this contract. But even if it should be held that all indirect charges are not to be excluded, certain of these charges that appellee has used as the basis for price increases are clearly indefensible.

An item of ''Research'' of 12 cents per ton was advanced by appellee as the basis of a portion of the

second price increase (Plf. Ex. 18, R. 563, 569). All but a nominal part of this was due to "new products research" (Def. Ex. A, R. 351, 354). This new products research even included a project seeking a way to eliminate gypsum (Wallace, R. 1093, 1094), the cost of which appellee's own interested expert, Alexander, testified definitely was "not a proper charge" (R. 1195). Clearly "new products research" has nothing to do with producing gypsum. As testified by Mr. Flick (R. 292):

> "By no stretch of the imagination, in my opinion, is New Products Research properly chargeable as a cost of manufacture of the by-product. You do not have to research on new products in order to dry, grind, and ship the by-product. It is just unrelated. It is not chargeable under any type of good accounting practice."

This testimony was uncontradicted. Indeed, Mr. Williams, assistant to appellee's president (R. 156), admitted that appellant's objections to this charge are justified (R. 175), and appellee's expert Farquhar testified that overhead dissociated from the manufacture of a particular product should not be allocated to it (R. 1132).

The contract permits price increases only as warranted by an "actual advance" in "the cost of *production* of *gypsum*" (R. 11). Research upon new products, products other than gypsum, conducted for the sole benefit of appellee, is manifestly no part of the cost of production of gypsum.

B. Appellee's charges for expenses of a general and administrative nature are not expenses of production or manufacture and under the contract may not be used as the basis of a price increase.

Appellee's charges to "cost of *production*" of by-product gypsum include, in addition to expenses relating to its manufacturing processes, numerous items of cost which are not elements of manufacturing or production cost. There is the following group of items, expenses of appellee's west coast operations (Watt, R. 930) of a general and administrative nature unrelated to *production* expense at the Newark plant, which account for 5 cents per ton of the 1944 increase and 6 cents per ton of the 1946 increase (Plf. Ex. 18, R. 563, 569):

West Coast General Expense

West Coast General Supervision

West Coast Telephone and Telegraph

West Coast, New York office (this is a portion of appellee's New York office expense, first allocated to its West Coast operations, then allocated to the Newark plant, and finally allocated among the products manufactured at Newark (R. 1051)).

West Coast Exploration

West Coast Subscriptions and Donations

West Coast Production Cost Control

West Coast Personnel Department

West Coast Group Insurance

To charge a portion of these expenses to gypsum under the contract with appellant, one must read the term "cost of *production*" as though the limiting word "production" were simply not there.

In addition to the unanimous testimony of the experts called by appellant,[13] appellee's own experts gave testimony that must exclude such expenses as these. Farquhar, testifying to the allocation of overhead to a product, spoke of "*factory* overhead" and "indirect charges *of the plant*" (R. 1111); he testified that things that do not relate to the production of the product would not be allocated to production cost (R. 1131); and that overhead dissociated from the manufacture of a particular product should not be allocated to it (R. 1132).

Maxwell's testimony that overhead could be charged was also limited to "overhead and expense *of the plant*" and "indirect charges *of the plant*" (R. 1136).

Alexander's testimony as to accounting principle was likewise confined to "plant overhead," and "indirect charges of the plant" (R. 1175-1177).

The meaning of these terms in accounting nomenclature is pointed up by the testimony of Mr. Flick. His testimony was that "cost of manufacture" or "cost of production" excludes expenses of a general and administrative character (R. 262). He further testified, by way of example, that overhead charged to his company's Gerlach, Nevada, plant (where no by-product is involved) includes overhead expense incurred *at that plant*—it includes no portion of the overhead from any other plant or from appellant's head office in San Francisco (R. 314).

Mr. Kenneth Pryor, of Price, Waterhouse & Co., likewise testified that in situations where overhead may be properly chargeable to a product, "cost of production"

[13]See note 10, p. 20, supra.

includes only manufacturing overhead, not general and administrative overhead (R. 666, 691, 701).

There is no conflict in the expert testimony on this point, except to the extent that Mr. Alexander (whose firm is appellee's regular auditor and who assisted appellee in the preparation of its case (R. 1186)) looked over an exhibit showing all the overhead charges appellee has made to cost of production of gypsum, and stated the bare conclusion that they were proper (R. 1184). And Watt, appellee's office manager, testified (R. 935, 936) that Plaintiff's Exhibits 15 (R. 276) and 17 (R. 557) correctly show the cost of production of gypsum. (These exhibits were schedules attached to appellee's answers to interrogatories (R. 272, 275, 557)). We submit that these self-serving conclusions are contrary to the overwhelming weight of the evidence, which requires that in any event these general and administrative expenses, dissociated from manufacturing operations at the Newark plant, be excluded from appellee's "cost of *production*" of gypsum.

IV.

APPELLEE CANNOT EMPLOY INCONSISTENT ACCOUNTING METHODS, IN TWO COST PERIODS BEING COMPARED, IN DETERMINING THE COST OF PRODUCTION OF GYPSUM. FICTITIOUS INCREASES IN INDIRECT SHIPPING EXPENSE AND THE EXPENSE OF AN AIR COMPRESSOR, RESULTING SOLELY FROM THE USE OF INCONSISTENT ACCOUNTING METHODS AND NOT FROM AN ACTUAL ADVANCE IN COST, MUST BE EXCLUDED FROM THE PRICE INCREASE.

If appellant is correct that indirect charges may not properly be employed under the contract in suit in determining price increases, the claimed cost items dis-

cussed in the following portion of appellant's argument would be excluded in any event. Assuming *arguendo* that indirect costs can be so employed, the seeming "increases" next considered must nevertheless be excluded, because they arise not from any increase in expense incurred by appellant, but solely from the use of inconsistent accounting methods in two periods being compared.

The most striking example of a fictitious cost increase, caused solely by a change in appellee's accounting method, concerns the item of indirect shipping expense. Appellee's third price increase was based upon a comparison of the cost of production of gypsum for the twelve months from July 1, 1945, to June 30, 1946, with the cost for the preceding twelve months' period from July 1, 1944, to June 30, 1945 (Plf. Ex. 10, R. 220, 221). Prior to June, 1945, indirect shipping expense was allocated on a value basis (R. 735, 736)—that is, the total indirect shipping expense was divided between gypsum and magnesium oxide in the proportion that the sales value of each bore to the total sales value of both (R. 909). On this basis, gypsum bore approximately 8½ per cent of this expense, since the sales value of gypsum is many times less than that of magnesium oxide (R. 952-955). In June, 1945, the basis of allocation was changed to divide the expense between the two in proportion to the tonnage of each product shipped (R. 909). Since the tonnages of the two products are nearly equal, gypsum was charged with approximately 40 per cent of indirect shipping expense in the twelve months from July 1, 1945 to June 30, 1946 (R. 956, 957), as against only 8½ per cent in the preceding twelve months. The cost

of handling gypsum actually remained the same (R. 958-959). Thus if 8½ per cent had been charged in both periods, or if 40 per cent had been charged in both periods, there would have been no increase in the indirect shipping expense charged to gypsum in the second period. In fact, due to appellee's use of inconsistent accounting methods in this allocation, appellee's books were made to show a 2 cent per ton increase (Plf. Ex. 18, R. 563, 573)—and that amount, a purely fictitious bookkeeping entry, was added to the price increase claimed.

On the subject of this "refinement" in accounting method, appellee's office manager Watt testified (R. 957):

> "Q. *Now, the effect of that change or refinement in your accounting methods, as I understand you to describe it, had the effect of loading onto gypsum a charge that formerly had been borne by your other products, isn't that correct?*
>
> A. *That is correct.*
>
> Q. And so far as the price that Pacific Portland Cement Company would have to pay for the gypsum, assuming that that was a proper charge of the cost of manufacture, *that change in method would increase the price Pacific would have to pay for its gypsum during the next period, wouldn't it?*
>
> A. It would.
>
> Q. *So that change or refinement in your bookkeeping process had the effect of substantially shifting the charge from your other products to gypsum, isn't that right?*
>
> A. That is correct."

Another such change was in the method of accounting for the cost of use of an air compressor. Prior to March,

1945, this item was included in "General Plant Expense," an overhead account (R. 1006). Beginning in March, 1945, a percentage was charged directly to gypsum (R. 1006, 1007). There was no change in the manner or degree of the actual use of the air compressor or in its cost (R. 1014); but the accounting change increased, by about four times, the portion of this item charged to gypsum (R. 1009), and increased the asserted price 1 cent per ton (R. 1010).

The effect of the two changes just discussed was artificially to raise appellee's "cost of production" of gypsum, and the price asserted, 3 cents per ton. Because of the long term of the contract, such minor differences cumulatively involve large sums. Gypsum production in the year ended June 30, 1946, was 36,658 tons (R. 565). At the rate of even 30,000 tons a year, the 3 cent difference involved in the indirect shipping and air compressor items would amount to about $14,400 over the sixteen-year period in suit. In addition, the principle involved is of the utmost importance and affects other items, both present and future, involving very substantial sums.

All of the accountants called by appellee testified that accounting methods must be consistent from year to year, where costs of production for two periods are being compared (Flick, Webster, Draewell, and Pryor, R. 261, 262; 340; 559; 622; 635; 644 and 715). There was no contradictory testimony of any kind. Indeed, the point is self-evident.

Mr. Watt, appellee's office manager, sought to justify appellee's several changes in accounting method on the

ground that the changes were instructed by appellee's New York office (R. 938, 939) "to accomplish uniformity of accounting practices between the various units of defendant company" (R. 938). Obviously, this is no justification for using the changes as a basis for increasing the price charged appellant. In addition, Mr. Watt when pressed admitted that some of the changes he made on his own initiative, including the change as to shipping expense above commented upon (R. 939, 1012). He admitted there were no written instructions on the subject of these changes from the New York office (R. 940, 941). He admitted he could recall no specific instructions and finally that his statement as to the New York office instructions for some of the changes was pure conjecture (R. 941, 942).

Appellee has made other changes in accounting method, as disclosed in its answer to one of appellant's interrogatories (R. 735-736).

> "Prior to January 1, 1944, all overhead expense was allocated on the basis of operating labor and repair labor expense. Commencing January 1, 1944, and until January 1, 1946, general overhead expense was allocated on a combined supervision and operating labor basis. Maintenance and engineering costs were allocated on a repair labor basis. Process control and control laboratory costs were allocated on a direct basis with the balance of the costs of these two departments pro-rated over the direct allocation. Commencing January 1, 1946, and during the period from that date to and including June 30, 1946, the same procedure was followed with the exception that general overhead was allocated on a combined operating and repair labor basis."

During the trial appellee had in preparation a tabulation showing what effect these changes had upon the cost of production of gypsum as shown by appellee's books (R. 913). On Wednesday, December 24th, Mr. Watt testified that he expected to have this tabulation on Friday, December 26th (R. 913). The trial closed on Friday, January 2, 1948 (R. 1174), the holidays having intervened, without his producing the tabulation. In the absence of this tabulation, appellant has no way of knowing the effect of these changes, and does not know to what extent these changes may have entered into the price increases appellee has claimed. If, as we confidently expect, this court declares that the use of inconsistent accounting methods in two periods being compared cannot reflect in price increases, no doubt the parties can ascertain and agree upon any effect these accounting changes have had without the necessity of taking further testimony.

V.

A CHANGE IN ACCOUNTING METHODS, AND NOT AN ACTUAL ADVANCE IN COST, IS THE ONLY BASIS FOR THE NEW CHARGE OF 23 CENTS PER TON FOR THE SULPHURIC ACID. THIS FICTITIOUS INCREASE MUST BE EXCLUDED FROM THE PRICE INCREASE.

The sulphuric acid charge is one of the largest single items in dispute. Its entire cost is now charged to gypsum (R. 286, 927). This is a wholly new charge. Never in the ten years this contract has been in effect was any charge whatsoever made to gypsum for sulphuric acid, until the period ending June 30, 1946 (R. 927; Plf. Ex. 18, R. 563, 565).

Appellee tried to explain the absence in all the prior years of any charge to gypsum for sulphuric acid on the basis that in those years it was all charged to bromine and now bromine is not produced (R. 926). It is an undisputed fact that when bromine was being produced, the sulphuric acid remained in the bittern after the bromine process (Melhase, R. 831), and that sulphuric acid has always served the same function in gypsum production, whether or not bromine is produced. Appellee's office manager, Watt, so testified (R. 1015). There has been no change in the process of production of gypsum, but merely a bookkeeping change. Mr. Watt testified that his change in the assignment of the charge for sulphuric acid had the effect of raising the price to appellant 23 cents a ton (R. 1015). Appellee clearly cannot raise its price to appellant 23 cents a ton because in one period it does not choose, and in a following period it does choose, to charge gypsum with a material that in operation has had an unchanged effect on gypsum and has at no time increased in cost.

Again, there is no conflict in the expert accounting testimony that good accounting practice requires the application of consistent accounting methods, and that the "increase" claimed because of the new sulphuric acid charge was merely the result of a change in accounting method and not based upon any increase in cost. This was the uncontradicted testimony of Mr. Flick (R. 285) and Mr. Pryor (R. 647). Appellee's accounting experts did not testify on the subject.

The fact that bromine production stopped does not justify this bookkeeping change. There was no change

in gypsum production or in the cost of sulphuric acid, but simply a loss of production of a different product in another portion of the plant. Appellee is free, if it wishes for its own purposes, to take this cost formerly borne by bromine and charge it to gypsum or any other product. It is not free, however, to claim a price increase under this contract because of that. Reassignment among appellee's products of an expense that has always been present is a change in accounting, and not an "actual advance" in that expense. Approving appellee's reassignment of this sulphuric acid expense as an "actual advance in [appellee's] cost of manufacture" would produce this result: When manufacture of bromine is resumed and the sulphuric acid again charged to it, the "cost of production" of gypsum on appellee's books will appear to go down. The price to appellant would remain, however, at the 23-cent higher level. A second discontinuance of bromine production would again shift the cost of sulphuric acid back to gypsum and a comparison of the two periods would again show a further increase in the cost of production in the total amount of the sulphuric acid cost. Because of this accounting treatment of sulphuric acid, appellant would then be paying an additional 46 cents per ton for gypsum, although no actual increase in cost ever had occurred. Alternate shutting down and resuming of bromine production in this manner could pyramid duplicating charges to a point where appellant would simply be forced to cancel the contract.[14]

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[14]In view of the prospective application of this court's decision, we feel it proper to bring to the attention of the court the fact that the fourth price increase, which was claimed by appellee after judgment was entered below (see note 3, p. 4, supra), includes

Obviously, such charges are grossly improper and have no relation to any "actual advance in [appellee's] cost of manufacture." It is completely untenable that interruptions in manufacture of a separate product determine the cost of production of gypsum, and the "actual advance" in that cost.

VI.

APPELLEE'S METHOD OF CHARGING DEPRECIATION HAS PRODUCED AN UNREAL INCREASE THAT DOES NOT ACTUALLY EXIST AND MAY NOT BE USED AS THE BASIS OF A PRICE INCREASE.

Appellee uses the "straight-line" method of calculating depreciation (R. 900), which concededly is a common one. It is hypothetical or theoretical, however. As the Supreme Court has pointed out, it is a mere calculation "based on averages and assumed probabilities" (*McCardle v. Indianapolis Co.*, 272 U. S. 400, 416). This method does not reflect the actual wearing out of the machine, but is simply a convenient method of writing it off (R. 409). It estimates the useful life of the equipment, and then charges to expense equal annual portions of its value (R. 902), so that when it is worn out, there has been placed in the depreciation account an amount equivalent to its value.

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20 cents per ton more for sulphuric acid, caused by precisely the accounting treatment of interruptions in bromine production that is described above. The result is that after this fourth increase appellant is charged 43 cents per ton for sulphuric acid, when in fact there has not been an actual advance of a single cent in the cost of sulphuric acid, nor any change in the use of this material in gypsum production.

Use of the "straight-line" calculation of depreciation for the purposes of the contract in suit, however, creates a distorted and unreal semblance of increase in gypsum cost, where no increase has in truth occurred. This distortion is revealed by the increase which appellee claimed in its 1943 cost of production over its 1942 cost of production. The dollar amount of depreciation charged to gypsum in 1942 was $12,221.68 and for 1943 it was $11,099.35—*an actual decrease of more than $1000* (Plf. Ex. 18, R. 563, 565). Because gypsum production dropped 23 per cent in 1943 from the quantity produced in 1942, from 31,826 tons to 24,431 tons (R. 565), however, appellee's calculations produced a depreciation charge for each ton of gypsum that was 7 cents higher in 1943 than it was in 1942 (R. 409, 410). There was no "actual advance" of 7 cents per ton in depreciation cost—the equipment does not wear out faster because less tonnage goes through it.

Although the tonnage of gypsum produced annually again rose to more than 33,000 tons and more (R. 565), appellee would have appellant pay, and continue to pay until the expiration of the contract, this 7 cents per ton charge which arose not from an "actual advance" in depreciation expense, but from a drop in production. Thus appellee would receive payments for depreciation which would pay for the gypsum equipment in much less than its useful life. It would receive payments which would replace the gypsum equipment at an annual production rate of 24,431 tons, when in fact the annual production has risen again to more than 33,000 tons.

Mr. Flick testified that where tonnage fluctuates and the object at hand is comparing the cost *per ton* in two accounting periods, the straight-line method gives a distorted result (R. 409, 410). Mr. Webster and Mr. Pryor also so testified (R. 514, 515; 653). Mr. Flick (R. 409-410), Mr. Webster (R. 514-515) and Mr. Pryor (R. 653) all testified that in such a situation the "unit of production" method of charging depreciation should be used: instead of charging depreciation by the straight line method, defendant should estimate the amount of gypsum that could be produced over the total life of the machinery and divide the value of the machinery by that figure (R. 409, 410). This would give a depreciation charge for each ton of gypsum that would not be affected by annual fluctuations in tonnage. This method would permit a true comparison of the cost of production of gypsum in one year as compared with another year, and would replace the gypsum equipment without requiring appellant to pay at a rate much more than sufficient to replace it.

Appellee's accountant Alexander, testified that the "straight-line" method of depreciation is proper to be used (R. 1184), and that the gypsum production equipment has a useful life primarily based on the time element, since it is subject to very heavy corrosion (R. 1185). He conceded that his opinion was not directed to any special situation posed by the contract in suit (R. 1190).

Appellant does not dispute that the "straight-line" method of depreciation is widely used, or deny that for its own internal purposes it is proper for appellee to use any

method of depreciation accounting it chooses. Mr. Webster stated that the use of the unit-of-production method for the purpose of one contract does not necessarily imply that the company must use that method in its own accounting (R. 515). The evidence is uncontradicted, however, that "straight-line" depreciation is improper for the purpose of determining whether, within the meaning of the particular contract in suit, there has been an "actual advance in [appellee's] cost of manufacture" of gypsum.

VII.

SUMMARY OF ACCEPTED AND DISPUTED ITEMS.

For the convenience of the court, there are set forth below in tabular form the asserted cost increases upon which the two price increases in litigation were based. The source of the data shown is Plaintiff's Exhibit 18 (R. 563-573). The parenthetical insertions indicate in brief recapitulation why certain items are objectionable. (The first increase of October 5, 1941, amounting to 18 cents per ton and raising the initial contract price of $2.80 per ton to $2.98 is not sought to be adjusted in this litigation.)

Price Increase of March 15, 1944

(inoperative until September 4, 1946, because of O. P. A. price control)

	Items of Cost	Cost Periods Compared Calendar 1942 Cost per ton	Calendar 1943 Cost per ton	Increase (or Decrease)
ccepted	Labor, operations	$ .26	$ .39	$ .13
	Labor, repairs	.12	.16	.04
	Compensation insurance and Social Security tax	.02	.03	.01
	Materials, operations	None	.02	.02
	Materials, repairs	.06	.07	.01
	Water	None	.01	.01
	Power	.15	.18	.03
	Fuel	.10	.14	.04
	Insurance	.01	.02	.01
		$ .72	$1.02	$ .30
isputed	Interdepartment water (indirect—allocated)	None	.01	.01
	Depreciation (determined on wrong basis—straight-line instead of unit of production)	.38	.45	.07
	Overhead:			
	"West Coast" expenses (general and administrative —not production cost)	.10	.15	.05
	New products research (not related to gypsum)	None	.12	.12
	Other overhead	.32	.55	.23
		$ .80	$1.28	$ .48

There were other items of cost charged in which there was no change. The total of all costs in 1942 was $1.93 per ton, and in 1943 the total was $2.71. The difference of 78 cents per ton was claimed as a price increase, to bring the prior price of $2.98 per ton to $3.76.

Price Increase of November 13, 1946

Items of Cost	Cost Periods Compared: July 1, 1944-June 30, 1945 Cost per ton	July 1, 1945-June 30, 1946 Cost per ton	Increase (or Decrease)
Labor, operations	$ .32	$ .35	$ .03
Labor, repairs	.21	.25	.04
Materials, operations	.02	.05	.03 Note 1
Materials, repairs	.11	.20	.09
Gas	.10	.12	.02
Direct shipping expense	.10	.15	.05
Insurance	.02	.01	(*.01*)
	$ .88	$1.13	$ .25
Note 1: Subtract $.01 of the increase shown in Materials, Operations, caused by change in accounting method as to air compressor			$ .01
			$ .24
Sulphuric acid (caused by change in accounting method)	None	$ .23	$ .23
Indirect shipping expense (caused by change in accounting method)	$ .11	.13	.02
Overhead:			
"West Coast" expenses (general and administrative—not production cost)	.13	.19	.06
Research, including new products research (not related to gypsum production)	.03	.07	.04
Other overhead	.58	.62	.04
Bittern (arbitrarily allocated)	.18	.16	(*.02*)
Depreciation (determined on wrong basis—straight-line instead of unit of production)	.38	.36	(*.02*)
	$1.41	$1.76	$ .35

There were other items of cost charged in which there was no change. The total of all costs in the twelve months ending June 30, 1945, was $2.52 per ton, and in the twelve

months ending June 30, 1946, the total was $3.12. The difference of 60 cents per ton was claimed as a price increase, to bring the asserted price of $3.76 per ton based on the raise of March 15, 1944, to $4.36 per ton.

Upon appellant's arguments, the March 15, 1944, increase would properly be 30 cents[15] per ton, bringing the prior price of $2.98 per ton to $3.28;[16] and the November 13, 1946, increase would properly be 24 cents[17] per ton, bringing the $3.28 price to $3.52 per ton.

VIII.

THE EVIDENCE REQUIRES THE ELIMINATION OF THE DISPUTED PRICE INCREASES CLAIMED BY APPELLEE. EVEN IF IT DID NOT, THE JUDGMENT SHOULD BE REVERSED, SINCE THE DECISION OF THE DISTRICT COURT WAS BASED UPON THE ERRONEOUS CONCLUSION THAT THE BURDEN OF PROOF WAS UPON APPELLANT INSTEAD OF APPELLEE.

The court below rested its decision that appellee had properly determined the cost of production of gypsum for the several periods involved, upon the ground that appellant had failed to prove that appellee's records were improperly kept and that the price raises were unjustified (Opinion, R. 73). This was error.

The law places the burden of proof of price increases upon the appellee, which has the affirmative of the issue

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[15]Since appellant initially questioned the charge for insurance on the gypsum portion of the plant but does not here urge objection to it, these figures and the preceding tabulation are adjusted to reflect the 1943 increase and the 1946 decrease in insurance.

[16]See footnote 15, supra.

[17]See footnote 15, supra.

whether its costs have increased and to what extent. The burden is not shifted to appellant merely because it brought the dispute into court by suit for declaratory relief in lieu of waiting to be sued for the price claimed.

Appellant could have attempted self-help by refusing to pay the disputed part of the price and leaving it to appellee to sue for the enforcement of its claims. It is conceded (R. 995) that in such a suit appellee would have to prove the existence of the cost increases asserted by it. But by that procedure, breach of the contract would have been risked. Instead, appellant invoked the court's aid under the declaratory relief statute (28 U.S.C. §400, now 28 U.S.C. §2201) provided for just such cases.

In this proceeding appellee seeks to lift itself by its own bootstraps. It has the affirmative of the issue as to the existence and amount of any "actual advance in [appellee's] cost of manufacture" of the by-product gypsum. It is the one possessed of complete facts and records as to its costs. In the normal course it would have to prove the cost increases. Yet merely because the matter is presented to the court by way of a declaratory relief suit, appellee asserts that its burden is to be lifted and its claims given *prima facie* validity. That is not the law. In the language of the court in *American Ins. Co. v. Bradley Mining Co.*, 57 F. Supp. 545, 548, the declaratory relief statute is not "an instrument of procedural fencing."

The question as to the burden of proof in actions for declaratory relief most commonly arises in suits upon insurance policies. The insured has the burden of proving the insurance company's liability under the policy, and

usually the issue of liability is raised in an action brought by the insured. When the issue is presented in a suit by the insurance company for a declaratory judgment of nonliability, the burden of proof rests upon the insured, who has the affirmative of the issue, just as it would in an action by the insured. The leading case is *Travelers Ins. Co. v. Greenough* (1937), 88 N.H. 391, 190 Atl. 129, 109 A.L.R. 1096. The opinion is so cogent that we quote at some length (pp. 1098-1099):

> "If the proceeding to determine the insurer's liability were one brought against it, the general burden of proof would rest upon its adversary. It would be on the defensive, and a case against it would require a balance of proof to warrant a judgment against it. It is no less on the defensive here. Whatever the form of the proceeding, and notwithstanding its nominal position as a plaintiff, the real situation is that it is defending against a claim of its liability. The relief it seeks is primarily to have the claim adjudicated. Its position that the claim is without merit is necessary, in order to show that the claim is a controverted one. By instituting the litigation it compels the claimant to take action in assertion of his claim. He is required to establish it to entitle it to validity. The plaintiff does not prevail unless the claim is defeated, but the claim is defeated if it is not proved, and it is for the claimant to furnish the proof.
>
> This view is thought to be just and fair. A contrary one would place the plaintiff in a position of undue disadvantage. Having the right to an adjudication of the claim without waiting for the claimant to institute legal proceedings, it ought not to suffer and to have to pay a price by exercising its right. No commendation of justice is perceived in making the plaintiff worse off by seeking a disposal of the con-

tentions between it and the claimant than by awaiting litigation commenced by the latter. * * *

Burden of proof is not imposed according to priority in taking legal steps to determine issues. And the Declaratory Judgment Act (Laws 1929, c. 86) discloses no purpose to shift the burden upon a party merely because he avails himself of the act. The statement of the act that a petition may be brought 'to determine the question as between the parties' does not change their relative normal positions in which one seeking redress must establish issues of fact in his favor by greater weight of evidence. Here redress is not sought except in the sense of relief from uncertainty. The right to have a disputed claim adjudicated does not predicate a duty to prove the claim unfounded."

This rule that the burden of proof remains upon the claimant or party having the affirmative of the issue, unaffected by that party's nominal position as defendant in a suit for declaratory relief, is followed in *Reliance Life Ins. Co. v. Burgess* (8 Cir. 1940) 112 F. 2d 234, *Thompson v. Baltimore & O. R. Co.,* 59 F. Supp. 21, *State Farm Mut. Automobile Ins. Co. v. Smith,* 48 F. Supp. 570, and *Liberty Mut. Ins. Co. v. Martel,* (1937), 88 N. H. 479, 192 Atl. 152.

This principle is also well established in the California law. *Roadside Rest, Inc. v. Lankershim Estate* (1946) 76 Cal.App.2d 525, 171 P.2d 529, was a case in which the plaintiff in the declaratory relief action alleged that the lease involved in the case had been modified; and it therefore had the burden of proving the existence of the modification. That the plaintiff had the burden of proof did not follow automatically from its position as plaintiff in the declaratory relief action—the court (p. 530) placed its

decision that the plaintiff had the burden of proof squarely upon "the fundamental proposition, reiterated in section 1981 of the Code of Civil Procedure, that 'The party holding the affirmative of the issue must produce the evidence to prove it * * *.' "

Only two federal district court decisions (in the Eighth Circuit) have stated the contrary position that the burden is always on the plaintiff, whether or not it has the affirmative of the issue.

Travelers Ins. Co. v. Drumheller (W.D. Mo. 1938) 25 F.Supp. 606;

Reliance Life Ins. Co. v. Fancher et al. (W.D. Mo. 1939) 30 F.Supp. 264.

The rule is otherwise in that circuit. Both of these district court decisions were discredited by the Eighth Circuit Court of Appeals in *Reliance Life Ins. Co. v. Burgess* (8 Cir. 1940) 112 F.2d 234. In that case the court held (p. 238):

> "It is a fundamental rule that the burden of proof in its primary sense rests upon the party who, as determined by the pleadings, asserts the affirmative of an issue and it remains there until the termination of the action."

This rule, that the burden of proof is upon the party who, as determined by the pleadings, asserts the affirmative of the issue, has been followed in other recent federal court decisions.

Philip A. Hunt Co. v. Mallinckrodt Chemical Works (E.D. N.Y. 1947) 72 F.Supp. 865, 873;

Lumbermen's Mut. Casualty Co. v. McIver (S.D. Cal. 1939) 27 F.Supp. 703, 704; affirmed (9 Cir. 1940) 110 F.2d 323.

In the case last cited the District Court for the Southern District of California held that the plaintiff insurance company which sought a declaratory judgment of non-liability had the burden of proof. This was correct because in that case the company in its pleadings set up what would have been an affirmative defense had the action been brought by the injured party. The court made it clear that the fact the suit was one for declaratory judgment did not shift the burden of proof (27 F.Supp. 704):

> "It is apparent therefore that insurer's contention that an unlicensed minor was operating the vehicle in violation of the state law and within the meaning of the exclusionary clause constitutes a special defense. Had this been a suit by the injured party directly against the insurer, such a contention would have been pleaded as a special defense. The fact that this is a suit for a declaration of non-liability, brought by the insurer as plaintiff does not alter the essential nature of the contention. It still amounts to a special defense."

And further on:

> "This conclusion is re-enforced by an examination of the pleadings. It is to be noted that the insurer's allegation consists, not of a statement that Jeff Clark *was not* operating the automobile, but of an affirmative assertion that Gracie Vaughn was driving it. The burden of proving that fact rests on the one asserting it."

In this case the pleadings leave no doubt that it is appellee who has the burden of proving affirmatively its right to increase the price of gypsum. As to the claimed increase of March 15, 1944, paragraph 7 of appellant's complaint (R. 3, 4) first set forth appellee's claim:

> "On or about January 14, 1944, defendant notified plaintiff that, effective March 15, 1944, the price of gypsum would be increased under paragraph (6) of said contract to $3.76 per ton, by reason of a further alleged increase of 78 cents per ton in defendant's cost of production of gypsum."

the complaint then denies the validity of this claim, alleging in the negative (R. 4):

> "On information and belief plaintiff alleges that if defendant's cost of production of gypsum had further increased at all it had so increased not more than 29 cents per ton."

In answer to this negative allegation, paragraph 4 of appellee's answer (R. 19) averred affirmatively:

> "In this respect defendant avers that defendant's cost of production of gypsum actually had increased 78 cents per ton and that pursuant to paragraph 6 of said alleged agreement, defendant was entitled to be paid $3.76 per ton for gypsum delivered under said alleged agreement after March 15, 1944."

As to the claimed increase of November 13, 1946, appellants negative allegations and appellee's positive averments were also in this form (Complt. par. 8, R. 4; Answer, par. 5, R. 20). Clearly, it is appellee who asserts the affirmative of the issue whether its costs have increased in the amounts claimed. Appellee alleges that its costs have so increased and that it is entitled to be paid the full amount of such increase. In the words of the court in *Lumbermen's Mut. Casualty Co. v. McIver,* supra, "the burden of proving that fact rests on the one asserting it."

IX.

THE PLAIN LANGUAGE OF PARAGRAPH (5) OF THE CONTRACT REQUIRES THAT THE CONFORMITY OF EACH CARLOAD OF GYPSUM TO THE CONTRACT SPECIFICATIONS BE DETERMINED. TO MAKE THAT DETERMINATION A SAMPLE OF EACH CARLOAD MUST BE TAKEN—NOT A COMPOSITE SAMPLE OF THE CONTENTS OF SEVERAL CARLOADS.

Paragraph (5) of the contract (R. 10) provides that in the event "* * * any gypsum ($CaSO_4$ 2 H_2O) tendered to Pacific hereunder * * *" does not meet a specified standard, "* * * Pacific shall have the option as to any such gypsum ($CaSO_4$ 2 H_2O) either to (1) refuse to accept and pay for such gypsum ($CaSO_4$ 2 H_2O) or (2) accept such gypsum ($CaSO_4$ 2 H_2O) and pay therefor * * *" a reduced price.

Gypsum is tendered or delivered to appellant in rail carloads, each car containing about 50 or 55 tons (R. 212, 213). Appellant has at times resold a substantial part of it in carload lots moving directly from the Westvaco plant (R. 386). If a carload of gypsum is tendered to Pacific which does not meet the standard prescribed, it is clear on the face of paragraph (5) that the alternative remedies specified apply to that carload. There can be no doubt that under the express language of paragraph (5) appellant could refuse to accept and pay for the gypsum contained in that carload. The optional remedy of acceptance and payment at the reduced rate is obviously coextensive. In short, gypsum is tendered in carload units of shipment and appellant's alternative remedy applies to each carload unit tendered. There is no warrant whatever in the language of paragraph (5) for an interpretation that the option of rejection, or ac-

ceptance and reduced payment, applies only to the aggregate quantity of gypsum shipped in a week or in a 24-hour day, however many carloads might be shipped that week or that day.

For over nine years after entering into this contract appellee consistently construed the contract as above set forth. To apply the specifications clause of paragraph (5), laboratory analyses must be made of samples of the gypsum tendered. For nine years appellee took samples of each carload and furnished them to appellant's laboratory and its own (R. 212-213, 868). About a year prior to the trial, appellee for the first time refused to furnish carload samples (R. 213), asserting that the gypsum quality should be determined from a composite sample representing a week's production of gypsum or approximately twenty carloads. It has since furnished appellant only such composite samples (R. 213, 868-869). Appellee's western manager, Wallace, admitted to appellant that the change was made to eliminate appellant's price deductions for below-standard gypsum, as there would be averaging out of good and bad in a 20-car sample (R. 214). Clearly this is directly in violation of the contract, which gives appellant the right to reject or deduct for "any gypsum * * * tendered" that does not meet the specifications.

The court below decided upon a method of sampling unknown to the contract or to the prior practice of the parties, and one not contended for by either. It decided that a composite sample of all gypsum shipped in a 24-hour day should be used. It did so solely upon the ground that gypsum is fungible in nature and is shipped in bulk and

stored in quantities up to 500 tons (R. 57, 61, 65-66). While it is true that some gypsum is stored by appellant, it is also true that large quantities are shipped in carloads directly from appellee's plant to appellant's customers (R. 386). In any event, the facts recited by the court are entirely immaterial to the question presented. Those facts in no way justify ignoring the clear meaning of the language of paragraph (5) and ignoring appellee's nine-year recognition of that clear meaning. In deciding as it did the lower court was without any support in the contract or in the evidence.

CONCLUSION.

We respectfully submit that for each of the foregoing reasons and in each of the particulars above specified, the judgment of the court below is erroneous and should be reversed.

Dated, San Francisco, California,
March 21, 1949.

Respectfully submitted,
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